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## Book Review:

# PRODUCT DEVELOPMENT IN ISLAMIC BANKS

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## BOOK CONTENT

Since its establishment in the 1970s, Islamic finance has achieved considerable growth and gained significance in the global financial industry. Compared to Islamic insurance (*takaful*) and Islamic equity and debt capital markets, which have also successfully taken off and developed well, the Islamic banking sector still holds the largest chunk of the global Islamic finance industry (IFSB, 2015). It can be seen that, despite the prevailing economic and political situations in some major countries, Islamic banking assets were able to grow strongly by 16% in 2014, to which the highest contribution was achieved by Gulf Cooperation Council (GCC) (EY, 2015).

Looking forward, the performance of the Islamic banking industry is still projected to have a positive trend, driven by the potential unmet demand (IFSB, 2015). Islamic banking products are even getting more attention from non-Muslim customers as they find the schemes particularly attractive or ethical. On the other hand, concerns also arise since the industry has not yet able to capture the interest of most Muslim customers – the supposed captive market for Islamic finance (Alim, 2014). In dealing with Islamic banks, Muslim customers involve religious motivations in varying degrees. In this case, the authenticity and the extent to which the contracts, products and the banking practices adhere to the *Shariah* (Islamic law) rules and principles are considered to be very critical.

Additionally, as part of an Islamic economic system, it is expected for Islamic financial products and practices to fulfil the social role by catering to the social needs of the society. More specifically, since the goal of an Islamic economic system is to realise the objectives of *Shariah* (*maqasid al-Shariah)*, Islamic finance is expected to contribute to achieving the economic growth, justice, and equity (Ahmed, 2011). These legal and foundational elements constitute the points of difference between conventional finance and Islamic finance. At the same time, they have increased the complexity of the Islamic financial instruments.

Indeed, the Islamic banking industry has numerous challenges to overcome in order to secure its future growth, especially with consumers from various segments becoming more demanding as they seek new and innovative products that could satisfy their needs. In that regard, the full understanding of product development in Islamic banks is becoming more crucial. Unfortunately, there is a lack of studies on this subject and it is insufficiently addressed in most Islamic finance books. Hence, this book, entitled ‘Product Development in Islamic Banks’ by Habib Ahmed, attempts to fill the gap in the literature.

This book is part of the ‘Edinburgh Guides to Islamic Finance’ series. It is the first book that is able to provide an in-depth explanation of the nature and issues surrounding the practice of product innovation and development in Islamic banks. At the beginning of the book, Ahmed criticizes Islamic finance for its failure to fulfil the *Shariah* (social and legal) requirements (p. 2). As briefly mentioned above, Islamic products should satisfy both the form (the contractual construct and legal requirements) and the substance (by satisfying the objectives of *Shariah* at the contract level) of Islamic law from the legal perspective, and also fulfil the social needs of the society (p. 165). However, he argues that in current practices, *Shariah* requirements are 'being diluted' (p. 2). In most situations, only the technical forms are often met, while the substance and spirit are not. As a result, many available products are considered too similar to the conventional ones. It means that the products are often developed by replicating the interest-based financial products and instruments currently available in conventional finance, thus, the essence of Islamic finance is overshadowed as the products move further away from using risk-sharing modes and equity-based instruments. Indeed, the Islamic banking products are not created in isolation. Therefore, in this regard, this book aims to 'explain the circumstances under which products are developed and ascertain why Islamic banks are unable to use products that satisfy the legal and social *Shariah* requirements' (p. 6).

The first chapter of this book further provides an overview of the practices in Islamic banking industry and the surrounding debates. It also explains the foundational concepts of innovation and product development, particularly concerning financial products.

In chapter two, Ahmed introduces the basic principles and concepts of Islamic law related to economics and finance, including the overview of the sources and methodology of Islamic law. As a foundation to help understanding of the book's subsequent content, he also explains about contracts, including major types of nominate contracts as a fundamental component in financial transactions. Furthermore, he also discusses *riba* and *gharar* – the major prohibitions in Islamic law – beyond their common forms, namely interest and gambling or speculation. Overall, this chapter is very helpful for those who have limited or no prior knowledge of Islamic finance. The interesting part of this chapter is, however, the explanations on the development of approaches to Islamic law used in developing Islamic financial products. From methodological perspectives, a concept such as 'necessity' could turn an originally unlawful ruling into a lawful one (p. 47). Furthermore, from contractual perspectives, adopting and adapting conventional financial products by removing the unlawful components or creating a new product by combining multiple traditional contracts seem to be the most common method (p.49). The former approach is what Iqbal and Mirakhor (2007) mentioned as 'reverse engineering' in Islamic finance.

In the next chapter, Ahmed starts to focus on Islamic banks and underlines the holistic environment and influence surrounding their product development process. In the institutional environment, he identifies four major forces, namely legal regimes and laws, regulatory and supervisory regimes, the *Shariah* governance system, and dispute settlement institutions. These factors are often forgotten by *Shariah* experts and critics, although they exert powerful forces in shaping the industry. The laws and regulations determine what type of financial institutions could be established and what type of activities could be carried out. As a consequence, various Islamic banking models exist across different laws and regulations in different countries. In many countries, Islamic banking laws do not exist, hence creating impediments in the development and operation of Islamic banks. Most conventional banking laws that already exist also may not approve the typical activities in Islamic banks, such as trading (*murabaha)* and investing in equities (*mudarabah* and *musharakah*). Under these circumstances, Islamic banks are forced to use the organisational format and products that have the same substance with the conventional financial system adopted in the country.

Following that, the book also describes the evolution of Islamic banking models over time and how different banking models have had an impact on the balance sheet structure and the products offered. It gives an insight into how the model has evolved from the preferred 'two-tier *mudarabah* model' (p. 73), where profit and loss sharing modes are used on both asset and liability sides, to 'one-tier *mudarabah* model' (p.74), where debt-based modes of financing are used on the asset side, and finally to the controversial *tawarruq*-based model (p. 75). Additionally, in contrast to other Islamic finance books around, this book also provides a thorough discussion on the various risks in Islamic banking, even down to the financial risks involved at different stages of the transactions (p. 87-93).

In chapter four, Ahmed starts to touch deeper on the product development system. He analyzes various available theories on innovation and product development process and elaborates them for Islamic financial products. He identifies three phases of product development cycle for Islamic banks (p. 108): 'idea generation and acceptance', 'converting concept to product', and 'commercialisation', and then discusses each of their strengths and weaknesses.

Following the demonstration of the product development process in chapter four, this book presents empirical results on the product development practices in Islamic banks which are collected by conducting two comprehensive surveys involving 20 Islamic banks in 12 countries. The results cover the assessment of the strategic approach, resource availability, and features of product development cycle in those Islamic banks. Above all, this empirical analysis is the most impressive part of this book, distinguishing it from others on similar topics.

Drawing on the foundational concepts explained in the previous chapters, in chapter six, Ahmed attempts to discuss the types of Islamic financial products developed by Islamic banks and their surrounding issues and controversies. He created an original classification of Islamic financial products into three categories (p. 167-168): '*Shariah*-based products' (the most ideal types of product as they adhere to both the social and legal requirements, and meet the social goals); '*Shariah*-compliant products' (compliant with the form and substance of Islamic law, but fail to meet the social goals); and 'pseudo-Islamic products' (only conforming to the legal form of Islamic law). Furthermore, this chapter also discusses the potential product space (including all the possible modes for a product) and touches some less common products, such as overdraft facility (p. 174) and Islamic synthetic forward (p. 176).

Then, the book introduces the set of viable products that Islamic banks could use under institutional and organizational constraints. In some cases, *Shariah* compliance could be forced to be forgone considering limited products available due to the constraints. However, in some cases, banks choose to opt for pseudo-Islamic products despite the availability of *Shariah*-compliant products, a situation which is not recommended for Islamic banks but often something that could possibly happen. Indeed, some conflicts might arise when Islamic banks are faced with the 'trade-offs between economic factors and *Shariah* requirements' (p. 187). Thus, this chapter demonstrates the reality of the interrelationships between the influences and forces that determine which legal and *Shariah* requirements to meet in Islamic banks.

Further, in the next chapter, Ahmed provides several suggestions about what should be carried out to move a step forward towards a *Shariah*-based Islamic financial system. Various measures should be made at different levels. Among those recommendations are: strengthening the institutional framework and infrastructure; utilising a more appropriate organisational formats; investing more in the research and development to develop new products through a new approach to innovation; and last but not least, making some improvements in the methodological approaches in deriving *Shariah* rulings and on the *Shariah* governance process.

Throughout the book, he emphasizes many times the way the real practice of Islamic banking has diverged from the normative aspirations of Islamic finance. In his view, the increasing adoption of pseudo-Islamic products that ignores the substance and spirit of Islamic law have raised serious concerns for the future of Islamic finance since they defeat its purpose (p. 224). According to him, a lot of changes should be made beyond the product level to serve better the social needs of the society in order to manifest the *Shariah*-based Islamic finance. In this regard, he suggests that Islamic finance should move away from the currently established banking model and that it needs to be re-positioned by implementing other innovative organisational forms and practices. He also stresses the important role of a *Shariah* governance framework and the quality of *Shariah* supervision in guiding the future direction of Islamic financial industry to conform to the *Shariah* requirements.

Overall, this book has utilized a holistic approach in looking at the realities and issues concerning the development of Islamic banking despite the financial success. It challenges readers to learn the complexities of the development of Islamic financial products. It enhances the awareness that Islamic products do not exist in a vacuum. A lot of factors and forces are influencing how Islamic products are developed, starting from the *Shariah* requirements, infrastructures, stakeholders, and financial dimensions.

This book is recommended as a piece of primary literature for students, researchers, practitioners, and regulators to learn about the basic concepts and the practical reality of Islamic banking. The earlier chapters reviewed the fundamental principles of Islamic laws used and examined well the features of Islamic financial products, providing a foundation for those with no prior knowledge of Islamic banking and finance. Each of the explanations is also completed with examples to make it easier to relate them to the current state of Islamic financial industry. This book also has a glossary of the Arabic terms used, thus, making it easier to understand.

Although not much long time has passed since this book was written, it is recommended that an updated version is released. In recent years, a call has been made to move away from the label of 'Islamic' to capture a wider market (Alim, 2014). Instead of using the term Islamic banks, currently, practitioners have been using the term 'participation banks'. It serves as a starting point in differentiating the *Shariah*-based products and pursues more authentically Islamic financial products. Therefore, it would be great to see the progress of product development issues under the new label.

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